

Internal Revenue Service
memorandum

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to: District Counsel, [REDACTED] CC: [REDACTED]
Attn: [REDACTED]
Special Litigation Assistant

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED] ([REDACTED])

This is in response to your requests for tax litigation advice dated January 24, 1989 and March 9, 1989.

ISSUES

1. Are individual coal piles a type of inventory used in the production of electricity or a supply type of inventory which should be expensed as utilized? 0471-0000; 0471-1000; 0471-0100.

2. Which method of valuation (FIFO, LIFO, or weighted average) should be used to value taxpayer's coal piles? 0471-0200.

3. Considering that the taxpayer uses an average price per ton of coal (based upon a weighted average of its most current coal purchases) to value its coal piles, should an error adjustment be made to the value assigned by the taxpayer in its weighted average computation? 0471-0200.

4. If the Service disallows adjustments to historical book inventory figures, is the Service correcting errors or changing taxpayer's accounting method? 0446-1900.

CONCLUSIONS

1. Electricity is an inventoriable good, and the coal consumed in the generation process is an inventoriable indirect cost allocated to the electricity produced through the cost of goods sold determination.

2. Based on the facts presented, it appears that taxpayer may be able to rebut the FIFO presumption and justify an average cost method.

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3. Although an error adjustment to taxpayer's estimate seems reasonable, we believe that the answer to this question depends upon further factual development.

4. Disallowed adjustments to book inventory figures are changes in taxpayer's method of accounting and require a section 481 adjustment.

FACTS

[REDACTED] ([REDACTED]) is the [REDACTED] electric utility in [REDACTED]. Its headquarters are in [REDACTED], and it operates subsidiaries in [REDACTED] ([REDACTED]), [REDACTED] ([REDACTED]), [REDACTED] ([REDACTED]), and [REDACTED] ([REDACTED]).

[REDACTED] maintains a perpetual inventory record of its coal reserves for its coal-fired electric plants by weighing the coal as it comes into the plant, and again weighing the coal as it is conveyed to the furnaces. The difference between the coal delivered and the coal burned is considered retained by the company as "inventory." [REDACTED] recognizes that its scales are often inaccurate, and it utilizes a backup method to test its perpetual book coal pile inventory by utilizing aerial surveys. These surveys are conducted annually or biannually, depending on plant megawatt capacity, in order to determine quantity of coal in inventory and to compare that value with book inventory and to correct accumulated errors in book value.

The company has approximately [REDACTED] coal piles located at [REDACTED] different plants throughout its operating system. The accounting procedures for these piles are as follows:

- A. As coal is delivered or removed for use from each coal pile, it is weighed on scales. Based upon these measurements, the amount of usage is perpetually booked.
- B. When the scales get out of balance, the amount of coal located on each pile becomes unknown.
- C. To determine the reliability of the above perpetual inventory records, the company has conducted coal pile aerial surveys. This is done twice a year for each plant larger than 1,000 megawatts, and once a year for plants that produce less than 1,000 megawatts.

- D. Based upon the results of the surveys, adjustments are made to the coal inventory accounts. These adjustments are strictly based on the differences between the aerial survey and the perpetual inventory records.

In the aerial survey, a plane passes over a coal pile or piles and takes a picture of the coal pile from a given altitude. Certain pylons or standards are placed around the coal piles and through the use of calculus, a volume calculation is made of each coal pile. In conjunction with the aerial surveys, core density and moisture samples are taken of the coal piles. Through the use of these calculations, the tonnage of coal contained in each pile may be calculated, and a dollar value assigned to the coal inventory. To the extent that the aerial survey is substantially different from the perpetual inventory records, the inventory records were adjusted roughly to the extent of fifty percent of the difference.

There are inherent inaccuracies in both the aerial surveys and the perpetual inventory records. For example, the volume computations are based upon some ground control reference targets which are not permanent structures; that is, the height and placement may change between surveys.

The following is the taxpayer's method of adjusting coal inventories for its [REDACTED], [REDACTED] and [REDACTED] and those [REDACTED] plants located in [REDACTED]:

- A. If the plant has a capacity greater than 1,000 megawatts and the difference between the perpetual inventory and the aerial survey is less than 3% there is no adjustment recorded.
- B. If the plant has a capacity greater than 1,000 megawatts and the difference between the perpetual inventory and aerial survey is greater than 12% the adjustment is limited to 1/2 of the 12%.
- C. If the difference between the aerial survey and the perpetual inventory is between 3% and 12%, the adjustment will be recorded to the extent of 1/2 of the difference. For plants with capacity less than 1,000 megawatts the direction of this difference must be the same for consecutive periodic inventories. If this requirement is not met, no adjustment is recorded.

The method of adjusting coal inventories for all other plants is as follows:

- A. The difference between the aerial surveys and the perpetual inventory will be recorded to the extent of 1/2 of the difference.
- B. If the plant capacity is 1,000 megawatts or less and the adjustment is 50,000 tons or 7% of the book value, arrangements should be made to take a second survey, and the results of the second survey will be recorded as above.

All adjustments are priced at the average unit cost per ton during the month that the adjustment is recorded.

With respect to issue three, [REDACTED] uses a weighted average of its coal purchases for the month the adjustment is recorded to determine the adjustments to its historic book inventory figures. That is, after calculating the volume in tons of the various coal piles at any location, and having concluded that its coal inventory increased or decreased by a given number of tons of coal, [REDACTED] multiplies that number of tons of coal times the weighted average price per ton, to determine the dollar adjustment to be made to its historic book inventory figure.

You have indicated that you do not believe [REDACTED] has procedures requiring the utilization of "old" coal prior to the utilization of newly purchased coal. You also believe that [REDACTED] would be unable to argue that it uses new coal before it uses old coal to generate electricity. Rather, you believe that as coal is delivered, it is placed on one of many coal piles, which are used in an irregular manner.

Accordingly, you believe that the valuation method used by [REDACTED] fails to reflect the value of the coal added to or depleted from taxpayer's coal piles. By using a weighted average of only its most recent coal purchases, [REDACTED] is probably using the most expensive coal in determining increases or decreases to its inventory figures. Therefore, if a weighted average is the correct calculation of the worth of the coal, you believe it should be based either on the average of all coal ever purchased by [REDACTED] or a weighted average of the coal purchased during the time frame covered by the survey, which is usually six months.

You also note that regardless of the method used to determine the price per ton of coal, the dollar amount is an estimate, and you believe that it may be proper to apply an error adjustment to the dollar figure just as a measure of variability

will be applied to the volume, density and moisture content calculations. That is, a measure of variability or error calculation should be computed with regard to the assigned price per ton of coal.

DISCUSSION

I. Are Coal Piles an Inventory Item or a Supply Item

Treas. Reg. §1.162-3, Cost of Materials, states that taxpayers carrying materials and supplies on hand may deduct the charges for materials and supplies only in the amount that they are actually consumed during the taxable year. If the supplies are incidental, however, and no record is kept of their consumption, the taxpayer may deduct the entire cost of the supplies purchased during the taxable year.

██████████, G.C.M. 36296, I-38-75 (June 3, 1975) concurred in Rev. Rul. 75-407, 1975-2 C.B. 196. The issue in the ruling is whether a public utility should continue to deduct the cost of fuel oil actually consumed and used to generate electricity distributed during the taxable year even though part of such fuel expense will be deferred for financial accounting purposes in accordance with the instructions of a state public service commission. The ruling states that taxpayer has properly deducted its fuel expense as a business expense under section 162.

Madison Gas and Electric Co. v. Commissioner, 72 T.C. 521 (1979) was litigated before the Tax Court in accordance with the views expressed in ██████████, O.M. 18473, I-243-75 (February 27, 1976) which were rejected by the court. At issue was the cost of coal used to generate electricity. The parties agreed at the outset that the cost of coal was deductible under section 162, and was not includible in inventory under section 471. At the same time, though, the court noted that inventories of materials and supplies might be permissible if such use would clearly reflect taxpayer's cost of material consumed. The court stated that taxpayer's method was not an inventory valuation method which entails an assumption that last in are first out (LIFO). Rather, the cost of materials consumed should be the actual cost. The issue was whether taxpayer's method of accounting for cost of coal consumed clearly reflected income such that respondent was arbitrary and abused his discretion in changing such method to FIFO.

The Service's position before the court regarding the treatment of coal used to generate electricity was that the coal could not be inventoried on a LIFO basis under either sections 472 or 162, if the flow of coal and its cost cannot be

specifically identified. That is, in the absence of proof that the taxpayer's method specifically identifies the actual coal consumed and used, a FIFO approach is required. According to Treas. Reg. §1.471-2(d) goods taken in inventory that have been intermingled and cannot be identified with specific invoices are identified under FIFO, absent a LIFO election.

Inventories of materials and supplies are not generally used but their use apart from inventory of finished goods, goods in process or materials and supplies held for sale or to become a physical part of merchandise intended for sale might be permissible if such use would clearly reflect the taxpayer's cost of material consumed. Id. at 551.

Because the coal actually consumed by taxpayer in Madison was the last coal delivered, and because taxpayer as a general rule used the average cost of the coal purchased each month as its cost of coal for the month in computing income, its method of accounting for the cost of coal resembled LIFO but this was merely a coincidence, according to the court. Taxpayer's method was not an inventory valuation method with a last in first out assumption. Inventories are not generally used in computing the cost of materials consumed, but rather the cost of materials should be the actual cost of materials consumed. Treas. Reg. § 1.162-3. The court was concerned with the proper computation of the actual cost of coal consumed. Id. at 553. The court stated that whether taxpayer's method clearly reflected income was a question of fact, and under the facts presented, the method used did clearly reflect income. The method closely approached a ton by ton accounting for the coal placed in use. Accounting for the cost of each piece of coal actually used on a ton by ton basis would be impractical, and the method used by taxpayer was as close an approach to actual cost as was practical. Id. at 555.

The court found that the coal reserve piles were not used as working piles. Rather, taxpayer basically consumed all coal delivered before the next delivery was due. Taxpayer's method of accounting, although not tagging each lump of coal as it was received traced the actual consumption of coal within parameters of de minimis differences. The last coal received was the coal first used with any excess being added to or deficiency taken from the most recent reserve pile edges. The only variations from actual consumption would be as a result of monthly averaging of costs in combination with the movements to and from the reserve piles. Taxpayer's obligation in order to clearly reflect its income was to determine in a realistic manner the cost of coal it actually used each year in the production of electricity, and this was done. Id. at 556-57.

[REDACTED], O.M. 19232 I-243-75 (March 27, 1980) agreed with the conclusion of the Tax Court in [REDACTED] that although taxpayer's method did not specifically identify the coal consumed, it did, under the facts, provide a close approximation of the cost of the coal actually consumed. Any discrepancies between the method of accounting and actual consumption were de minimis. The cost of coal was noted to be deductible under section 162 and reference was made to Rev. Rul. 75-407, holding that fuel oil consumed by an electric utility in the production of electricity is a section 162 expense.

O.M. 19232 concludes that the standard applied by the Tax Court in [REDACTED] is reasonable. "We agree that a taxpayer should not be required to use a FIFO method of accounting under Treas. Reg. §1.162-3 if the taxpayer can prove that, under the existing facts, its own method provides a close approximation of the cost of the actual supplies consumed each year with only de minimis discrepancies between the method of accounting and actual consumption." The general rule, of course, is that in determining supplies actually consumed, the use of FIFO is appropriate unless the supplies consumed and their cost can be specifically identified. In addition, O.M. 19232 notes that the Service should not allow a LIFO method in valuing materials consumed during the year if taxpayer can adequately establish consumption based on specific identification.

Treas. Reg. §1.471-1 provides that in order to reflect taxable income correctly, inventories are necessary where the production, purchase or sale of merchandise is an income-producing factor. In the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale must be inventoried. In addition, though, the full absorption method of inventory costing provides for direct and certain indirect production costs to be allocated to goods produced during the year. Treas. Reg. §1.471-11(a) states that in order to conform to the best accounting practices and to clearly reflect income as required by section 471, direct and indirect production costs must be used in the computation of inventoriable costs in accordance with the full absorption method of inventory costing. Treas. Reg. §1.471-11(c)(2)(i)(f) lists indirect materials and supplies as an indirect production cost which must enter into the computation of inventoriable costs.

Therefore, to the extent that manufacturing supplies are consumed in the production of another product, the cost of such supplies must be included in the inventory cost of such other

product and are not deductible under section 162. See Treas. Reg. § 1.471-11(c)(2)(i)(f) and Temp. Reg. § 1.263A-1T(b)(2)(iii)(F). The 1986 uniform capitalization rules apply to the manufacture of inventory goods and essentially parallel to the full absorption rules.

The cost of goods sold, therefore, includes indirect supplies consumed pursuant to either the full absorption rules or the uniform capitalization rules. Cost of goods sold is computed by adding to the inventory at the beginning of the tax year the cost of merchandise and materials, plus all other costs related to obtaining or producing the merchandise. From this total is subtracted the inventory at the close of the tax year; the remainder is cost of goods sold. When that figure is subtracted from total sales, the result is the amount of gross income from sales.

The first indication of a change in Service position with respect to the holding in Rev. Rul. 75-407 (fuel used in production of electricity is a section 162 deduction) occurred in [REDACTED], G.C.M. 38337, EE-151-79 (April 4, 1980). The G.C.M. discussed a revenue ruling, which was never published, but nonetheless represents current Service position. Both G.C.M. 38337 and the proposed ruling noted that Treas. Reg. § 1.61-3(a) provides that in a manufacturing business gross income means the total sales less the cost of goods sold, and that in generating electricity there is incurred a cost of goods sold. The cost of goods sold for purposes of sales of electricity is determined in accordance with the provisions of section 1.471-11 of the regulations, under which certain costs are taken into account by a manufacturer under the full absorption method of inventory costing.

At issue in LTR 82-16-008 (Dec. 21, 1981) was oil to heat the furnace which fires bricks in a brick manufacturing process. The ruling discussed Rev. Rul. 75-407 and impliedly distinguished it from the facts at issue. The letter ruling states that once the fuel oil has been consumed and used in operations it would be considered an indirect production cost of Treas. Reg. § 1.471-11(c)(2)(i) which must be allocated to goods produced in accordance with the full absorption method of inventory costing. Because this ruling accepts the holding of Rev. Rul. 75-407, the reasonable conclusion is that the author viewed the generation of electricity as not constituting an inventoriable good whereas the brick manufacturing process does produce inventoriable goods. The two major points in this ruling, though, are consistent with treating coal to generate electricity as a supply item which is an indirect production cost of the inventoriable good

(electricity) under the full absorption method. Neither fuel oil nor coal is inventoriable itself because it will not become a part of merchandise intended for sale. It is a supply item. Fuel oil (or coal) used in operations during the year is allocated under the full absorption method of inventory costing--an indirect production cost allocated to goods produced.

[REDACTED] O.M. 19995, I-233-85 (April 8, 1986) considered whether electricity was an inventoriable good pursuant to Treas. Reg. §1.451-5(c) and the treatment of advance payments. The advance payment regulations apply to goods properly includible in inventory. O.M. 19995 considers whether electricity is a good or service. Because electricity, which is manufactured in a power plant, is produced by the employment of labor and machinery resulting in a consumable product, it should be classified as a good. The O.M. states that there is considerable conflict among state Supreme courts on the issue, but that the weight of authority appears to be that the production of electricity by artificial means in a condition fit for use is generally regarded as a manufacturing process rather than a service.

The O.M. historically analyzed the advance payment regulations on the issue of whether electricity is properly includible in inventory and concludes that such requirement does not focus on the attributes of storage, enumerability or measurability. Rather, the focus is on availability. Because electricity is available through the normal course of supply, it should qualify as properly includible in inventory. See also Service's Brief to the Seventh Circuit in [REDACTED] in which reference is made to the stipulation of the parties that if the customer deposits at issue are determined to be income to taxpayer, taxpayer would be allowed to treat the deposits as advance payments of inventoriable goods.

The Customer Deposit Utility ISP Coordinated Issue paper also concludes that electricity is an inventoriable good for purposes of the advance payment regulations. The paper states that gas, electric and water utilities sell goods properly includible in inventory. Telephone companies, though, are deemed to provide services not inventoriable goods.

Announcement 86-65, Bull.1986-19, May 12, 1986, stated that the Service would not follow Orange and Rockland Utilities v. Commissioner, 86 T.C. 199 (1986). One of the Tax Court's conclusions was that the delivery of electricity and natural gas is the furnishing of a service rather than the sale of a good or product. The Service stated in the announcement that the

furnishing of electricity and natural gas constitutes the sale of a product or good rather than the sale of services. Thus, natural gas utilities are required to employ an inventory method of accounting for their gas, Rev. Rul. 78-352, 1978-2 C.B. 168; and gas and electric utilities may defer the reporting of prepaid income upon compliance with regulations governing prepayment for sales of goods. City Gas Co. of Fla. v. Commissioner, 47 T.C.M. 971, 975-78 (1984); Rev. Rul. 72-114, 1972-1 C.B. 124. Therefore, the utilities involved in the Orange and Rockland case were required to accrue income in accordance with rules applicable to sellers of goods.

[REDACTED], G.C.M. 39724 EE-171-86 (April 8, 1988) concerns the computation of income for purposes of section 501(c)(12) for electric cooperatives. The G.C.M. states that prior to 1977, it had been the longstanding position of the Service that there were no costs of goods sold with respect to the sale of electricity (electricity is not an inventoriable item) and that, accordingly, gross receipts were equivalent to gross income for purposes of the 85 percent member income test of section 501(c)(12), as applied to electric cooperatives. The G.C.M. cites [REDACTED], G.C.M. 37199, I-4620 (July 25, 1977) and G.C.M. 38337, EE-151-79 (April 4, 1980) concluding that income as used in section 501(c)(12) and applied to an electrical utility company, now is determined by subtracting from gross sales the cost of goods sold, as computed under Treas. Reg. §1.471-11, relating to the full absorption method of inventory costing.

Summary

Assuming that electricity is an inventoriable good, fuel consumed in the generation process is an inventoriable indirect cost allocated to the electricity produced for the cost of goods sold determination. The weight of authority of Service position since the late 1970's is that electricity is an inventoriable good. Therefore, the treatment of fuel as a section 162 supply item is incorrect, and Rev. Rul. 75-407 concerning expensing fuel used to generate electricity is in conflict. A recommendation for modification of the ruling is needed to reflect that the fuel supply item is an indirect production cost rather than a section 162 deduction.

Supplies are either deducted under section 162 or taken into account as an inventoriable cost pursuant to section 471 as used or consumed. To the extent that supplies are consumed in the production of another product, the cost of such supplies must be included in the inventory cost of such other product. Treas. Reg. §1.471-11(c)(2)(i)(f). The coal at issue is a non-

inventory item. Allocating a supply item as an indirect production cost under the full absorption method of inventory costing does not mean it is an inventoriable item itself. Rather, it is an inventoriable cost. Electricity is the inventoriable good. Inventory costing rules take precedence over section 162. Treas. Reg. §1.162-1(a) states that no item of business expense shall be included to the extent that it is used in computing the cost of property included in inventory.

We do note in this regard that O.M. 19995 discussed a secondary position should a court disagree that electricity is an inventoriable good. Therefore, a reasonable alternative position is that the coal at issue is a section 162 expense.

Madison Gas, supra, provides an important principle with respect to issue two. Although inventories of materials and supplies are not generally used, an acceptable valuation method of an indirect production cost, such as coal, may resemble an inventory valuation method. Taxpayer's valuation method must clearly reflect income and properly compute the actual cost of coal consumed. Id.

II. Method of Valuation for Coal Piles

A. Introduction

When it is impractical to trace the cost of essentially similar items, assumptions are made regarding which goods have been sold. When an inventory consists of a relatively small number of items, each with its own characteristics and cost, actual cost is ascertainable, and the use of actual cost to determine aggregate inventory cost is known as the specific identification method. The preferred specific identification method reflects actual physical flow and cost of goods purchased and produced. If specific identification is not possible due to intermingling or other reasons of infeasibility under taxpayer's accounting system, costing assumptions are used.

The assumptions used are FIFO, LIFO and any of several forms of average. Under FIFO the first goods acquired or produced are the first goods sold and goods remaining in inventory are the last goods acquired. Under LIFO it is assumed that the last goods acquired or produced are the first goods sold. Under a weighted average method, the total items is divided into the total cost (items acquired over the year) to arrive at an average cost which is then multiplied by the number of items remaining in inventory at yearend to arrive at the weighted average cost of the inventory.

For tax purposes, FIFO is authorized under section 471 and LIFO is authorized by election under section 472. Although the absence of or reference to average cost methods may suggest that average cost methods may not be used, there is no express regulatory or Code prohibition to the use of these methods. S. Gertzman, Federal Tax Accounting, 6-68. (1988).

Regulations contemplate that taxpayers will maintain appropriate inventory records and accounts so that the actual cost of goods may be determined. Regulations also contemplate that inventory balances shown in the accounts will be verified by physical inventories at reasonable intervals with discrepancies between book figures and actual physical inventories conformed to the physical inventories. Treas. Reg. §1.471-2(d) provides that where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred or sold, calculated upon the basis of the actual cost of goods acquired during the year, the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balance shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Although regulations anticipate that taxpayers will maintain accurate records and make physical counts of their inventories, it is often impractical to make physical counts or keep totally accurate records. Therefore, estimates must be made on a practical basis of the number of items on hand each year. Taxpayers are usually not required to adopt inappropriately expensive and time-consuming practices. Agents typically allow taxpayers to adopt practical means of determining the value of their inventories; that is, many taxpayers may use some method not wholly in accord with FIFO or LIFO. Id. at 6-69.

B. Average Cost

As stated, regulations indicate that where goods have been so intermingled that they cannot be identified with specific invoices, FIFO should be used unless LIFO has been elected. Yet, many taxpayers have used average cost for tax purposes where commodities are intermixed and stored for long periods of time prior to sale and average costing is the most practical method of inventory identification. Industries using average costing include tobacco, chemicals, food processing, lumber, natural gas and oil. Several commentators have concluded that an average cost method may be used where FIFO is impractical and LIFO has

not been elected. Id. at 6-71. Montgomery, Federal Taxes § 2.22 (39th ed. 1964) states that the average cost method is not usually allowed when identification or the FIFO method can be used. Thus suggesting that average cost could be acceptable if LIFO were not elected and FIFO were impractical.

There are several average cost assumptions. Average cost may be based on a simple unweighted average of costs incurred during the year or on a weighted average which would take into account both the cost and number of goods acquired at that cost during the year. Also simple or weighted costs may be based on a moving average which takes into account costs in beginning inventory and aggregates them with costs incurred during the year. This moving average approach has the effect of costing inventories on the basis of both current and prior year costs.

Service position on average costing is set forth in Rev. Rul. 71-234, 1971-1 CB 148 involving a taxpayer whose product required aging for a period of 1-3 years. The taxpayer used a moving average cost method. The ruling concluded that in a business requiring goods to be carried for lengthy periods and where an average cost method is used, income is assigned to a year, not upon the basis of annual transactions, but upon the basis of transactions spread over more than a year. The average cost inventory method failed to comply with the requirement for an annual accounting period.

The main problem identified in the ruling was the impact of costs incurred in prior years on the computation of inventory costs in the current year. Assuming a nonexistent or negligible impact (average cost is based only on costs incurred during the current year), we believe that the average cost method should be acceptable. See LIFO regulations in which taxpayers who must value increments to LIFO inventory for a particular year may value increments on the basis of average costs incurred during that year. Thus average costing is presumably acceptable where costs being averaged are costs incurred only during the current year. Treas. Reg. §1.472-2(d)(1)(i)(c). We believe that the use of an average cost method is subject to a clear reflection of income, reasonable accounting practice scrutiny.^{1/}

^{1/} See also Temp. Treas. Reg. § 1.263A-1T(e)(6)(iii) regarding revaluing inventory for taxable years after December 31, 1986, as if the new capitalization rules of section 263A had been in effect during all prior periods. Taxpayers may use reasonable estimates under a facts and circumstances revaluation. The weighted average method is available for taxpayers who lack sufficient data to revalue inventory costs under a facts and circumstances method which requires application of capitalization rules with the same degree of specificity as required of inventory manufactures prior to the Tax Reform Act of 1986.

The leading case dealing with the propriety of average costing is Ozark Mills, Inc. v. Commissioner, 6 B.T.A. 1179 (1927), acq. VII-1 C. B. 24 (1928), where taxpayer attempted to use a weighted average cost method (not a moving average method). The Service contended that the FIFO method was required. The Board of Tax Appeals viewed both FIFO and the average cost method as rules of convenience where competent evidence to the contrary is not shown. Under the circumstances, the Board concluded that neither FIFO nor average cost could be used because the specific identification basis was feasible.

Based on Ozark, we believe that the use of an average cost method may be reasonable in circumstances where the method is accepted for financial accounting purposes and reflects a flow of goods consistent with the average cost flow assumption as opposed to a FIFO cost flow assumption. Also, there is little reason for failing to approve an average cost flow assumption where the average cost is determined on the basis of costs incurred within the current year and does not include costs from the prior year.

C. Clear Reflection of Income Standard

Although "clearly reflect income" is not defined in the Code, the regulations and a number of court decisions have given meaning to the expression. The courts have indicated that to clearly reflect income, an accounting method must reflect income with as much accuracy as recognized methods of accounting will permit. See Wilkinson Beane, Inc. v. Commissioner, 420 F.2d 352, 356 (1st Cir. 1970); Caldwell v. Commissioner, 202 F.2d 112, 115 (2d Cir. 1953). Treas. Reg. §1.471-2(a) provides two tests to which each inventory must conform. It must conform as nearly as may be to the best accounting practice in the trade or business, and it must clearly reflect income. Treas. Reg. §1.471-2 (b) provides that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with Treas. Reg. §§1.471-1 through 1.471-11.

Treas. Reg. § 1-471-2(d) discusses FIFO and the requirement for verifying book inventories by physical inventories at reasonable intervals. Treas. Reg. § 1-471-2(e) provides that the taxpayer must satisfy the district director of the correctness of the prices adopted in the inventory.

In Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979) in considering whether an accounting method clearly reflected income, the Court looked to whether the taxpayer's use of the method hampered the Commissioner's duty to protect the public fisc. The Commissioner is vested with wide discretion in determining whether a particular method of accounting clearly reflects a taxpayer's income. If the Commissioner determines that a method of accounting does not clearly reflect income for tax purposes, that determination can only be overturned if it is determined to be arbitrary and capricious. As the Supreme Court stated in Thor Power, *supra*, 439 U.S. at 532:

This Court's cases confirm the breadth of this discretion. In construing 446 and its predecessors, the Court has held that "[T]he Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." Commissioner v. Hansen, 360 U.S. 446, 467 (1959). Since the Commissioner has "much latitude for discretion," his interpretation of the statute's clear-reflection standard "should not be interfered with unless clearly unlawful." Lucas v. American Code Co., 280 U.S. 445, 449 (1930).

The question of whether the Commissioner's actions in requiring a change in accounting for a material item constitutes an abuse of discretion is resolved based upon the facts concerning the taxpayer's business operations and the accounting activities in question. Taxpayers would have to show at trial that their method was permissible under the regulations and so clearly reflected income that the Commissioner's determination could only have been the result of arbitrary and capricious activity.

In Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979) the Court stated that even if an inventory method conforms to GAAP, it is still subject to the requirement that no method of accounting is acceptable unless it clearly reflects income. Thus, compliance with GAAP does not ensure that the method is proper for tax purposes. Taxpayers must prove that the method of inventory valuation used clearly reflects income, and the ultimate question of whether a particular method of accounting clearly reflects income is a question of fact. See e.g., Madison Gas and Electric Co. 72 T.C. 521, 555 (1979). In addition, if the taxpayer's inventory valuation method does not clearly reflect income, the consistent use of this method will not preclude the Service from adjusting the method. See, e.g., Lincoln Electric Co. v. Commissioner, 444 F.2d 491 (6th Cir. 1971).

Peninsula Steel Products & Equipment v. Commissioner, 78 T.C. 1029 (1982) discussed the clear reflection of income standard while determining that taxpayer could use inventories to compute costs of long term contracts. Taxpayer has a heavy burden in overcoming a finding by respondent that its method of accounting does not clearly reflect income. However, if the taxpayer succeeds in showing that the method it chose clearly reflects its income, respondent does not have discretion to disturb that choice. Whether a particular method of accounting clearly reflects income is primarily a question of fact and will vary from business to business and from factual situation to factual situation. Ordinarily, a method of accounting which is in accordance with generally accepted accounting principles will be regarded as clearly reflecting income for tax purposes if it is used consistently. However, an accounting method which conforms to generally accepted accounting principles but does not comply with respondent's regulations may not clearly reflect income. Thor Power. Where there is a choice of alternative methods of accounting with no suggestion that the method adopted is impermissible from an accounting standpoint, and the method is substantially in accord with the regulations, great weight (though not necessarily controlling weight) will be given to consistency. Treas. Reg. § 1.471-2(b). Id. at 1044-45.

Sometimes taxpayers have been permitted to use inventory methods that are not wholly consistent with the technical requirements of the regulations but are found to clearly reflect income. The overall important issue is the accuracy of taxpayer's valuation method. Taxpayers may thus use reasonable means for valuing inventories in conformance with normal industry practices, for example, where it would be unreasonable to require strict adherence to regulations. Subjective valuations may not substitute for available objective evidence.

In E. Rauh & Sons Fertilizer Co. v. Commissioner, 12 BTA 468 (1928), acq. VII-2 CB 33 taxpayer manufactured and sold fertilizer and animal foods. The raw materials and mixed products were stored in piles of 35 to 40 feet in height, 90 feet wide and 150 feet long. The method at issue had been used by taxpayer for fifteen years. Two company officers made independent physical inventories and used market values based on their experience and personal opinions. They discussed their differences and established and agreed upon the quantities and the value of the inventory. The court viewed the evidence as to the correctness of the procedure as convincing and deserving of confidence. Also noting the consistency of taxpayer's practice, the court held that methods of inventorying are frequently modified to suit the circumstances, and there was no basis to conclude that income was not clearly reflected or that good

accounting principles had been violated. The court approved the accuracy of taxpayer's valuation method based on the reasonableness and consistency of the method and the impracticability of any other method.

In Morrie Chaitlen v. Commissioner, T.C. Memo. 1978-6 taxpayer purchased, processed and sold scrap metal. The metal was stored in piles separated by grades. The court found that taxpayer valued inventory under a method peculiar to the scrap metals industry in which an officer would visually estimate quantities of various categories of scrap and determine a price for the scrap based on market quotes, market conditions and the processing stage in the inventory. The taxpayer did not maintain a perpetual inventory to assist in valuation. The court noted that section 471 prescribes that inventories may be determined using a method which conforms to the best accounting practice in the trade or business and which most clearly reflects income. The regulations are flexible in recognizing industry custom and accord great weight to consistency which should lead to a clear reflection of income. Treas. Reg. § 1.471-2(b). The court stated the issue as whether taxpayers established that the inventory valuation method was acceptable in the industry and whether it was properly applied. The court found that the inventory valuation practice used was acceptable in the scrap metal industry and had been consistently applied by the taxpayer. The court accepted the valuation of officers of an acquiring corporation because they were experts in valuing metals and their estimate was held to be the best evidence in the record.

Ozark Mills, supra, involved valuing raw cotton inventories. The court held that neither the FIFO method, as advocated by the Service, nor the weighted average method proposed by taxpayer was correct, but that taxpayer could compute its actual cost of goods. The last cotton purchased was used first. Taxpayer also maintained a perpetual inventory from which it was possible to determine the cost of raw cotton on hand and the cost of cotton entering the manufacturing process. Upon taking a physical inventory, taxpayer revised its inventory using a weighted average method. Taxpayer objected to the Commissioner's presumption that the goods on hand were those most recently purchased when the facts rebutted such presumption, and maintained that an average cost based on acquisitions of cotton throughout each year and the cost of cotton on hand at the beginning of each year, would furnish an inventory valuation which clearly reflected income.

The court held that FIFO is not a conclusive presumption, but rather is a rule of convenience where competent evidence to the contrary is not shown. In this case, the taxpayer used the

last goods purchased first. Furthermore, taxpayer showed that it kept a perpetual inventory in which it listed each bale of cotton purchased with actual weight, price and vendor name. When the cotton was used, the bale was checked off, and at the end of any period it was possible to determine the number of pounds on hand and actual cost. It was, therefore, not an average cost but a true cost based on actual purchases of cotton not consumed.

At issue in [REDACTED], G.C.M. 38362 I-11-79 (April 30, 1980) was the use of the average cost method of valuing inventory, and the conclusion was that its use contravened the FIFO presumption in Treas. Reg. §1.471-2(d). That section provides that when goods are intermingled and cannot be specifically identified, the taxpayer is required to value inventory on the assumption that the goods on hand are the goods most recently purchased or produced. However, the presumption found in the regulation is rebuttable by competent evidence to the contrary. If the taxpayer can demonstrate that another valuation method (such as average cost) more accurately approximates the actual flow and cost of goods sold than the FIFO method, the presumption will be rebutted and taxpayer will be permitted to use that method. Otherwise, the taxpayer will be required to use FIFO. See Ozark Mills.^{2/} Under the facts at issue, the costs determined under the average cost method and the FIFO method merge as the rate of inventory turnover increases, and the costs under both methods did not differ greatly. The G.C.M. concludes, though, that the FIFO method more closely approximates the actual physical flow and cost of goods sold than does the average cost method. Therefore, the use of FIFO is required.

G.C.M. 38362, was followed by [REDACTED] O.M. 19339 I-11-79 (October 24, 1980). The Office of Tax Legislative Counsel had recommended that Treas. Reg. §1.471-2(d) be amended to provide that the average cost method was an acceptable inventory method. The O.M. reflects the decision of the various Chief Counsel divisions that a regulations project should be initiated to provide for the average cost method of inventory valuation. To date, though, the FIFO presumption in the regulations has not been changed.

^{2/} See also 10 RIA Federal Tax Coordinator G-5112: any method which comes within the best accounting practice of the particular trade or business and which clearly reflects income will be acceptable. However, intermingled goods are deemed to be sold on FIFO, and taxpayer must overcome that presumption to obtain the use of the average cost method. The rule is merely a matter of convenience and can be overcome by competent evidence to the contrary.

In summary, the appropriate inventory valuation method is whichever method clearly reflects income and represents standard industry practice and actual use of the piles. FIFO is a rebuttable presumption where actual use cannot be established. That is, if taxpayer can establish that FIFO is not appropriate, he may be able to establish that use of a weighted average is the most reasonable method.

Based on the facts that you have presented, it appears that [REDACTED] may be able to justify an average cost method as there is apparently no basis to allege that their coal use is FIFO. See Ozark Mills, supra, where the court allowed neither FIFO nor average cost because the taxpayer's records allowed the use of specific identification. Also see GCM 38362, average cost contravenes the FIFO presumption. Taxpayer would have to demonstrate that average cost more accurately approximates actual flow of goods and cost than FIFO and thus rebuts the FIFO presumption.

III. Error Adjustment to the Estimated Value of Increases or Decreases to Inventory

The two questions posed by issue three are related to taxpayer's use of the weighted average. Because taxpayer is unable to differentiate between new and old coal, the Service believes that the valuation method used fails to reflect an accurate value estimate of the coal added to or depleted from inventory. By using a weighted average of [REDACTED] its most recent coal purchases, [REDACTED] may be using the most [REDACTED] coal in its determination of increases or decreases to [REDACTED] inventory figures. Therefore, if a weighted average is the correct calculation of coal value, should the weighted average be either the average of all coal ever purchased or a weighted average of all the coal purchased during the time frame covered by the survey, usually a six month period?

Our opinion is that the correct method is a weighted average of the coal purchased during the time frame covered by the survey. Because the Service is on record as disagreeing with use of a weighted average covering more than one taxable year, we do not believe that the average of all coal ever purchased is appropriate. See Rev. Rul. 71-234, supra.

The second question involves taxpayer's methodology. Regardless of the exact method used to determine the price per ton of coal for the increase or decrease to inventory, the assigned value is still an estimate. Therefore, you state that it may be proper to apply an error adjustment to the dollar figure, i.e. a measure of variability. The question is whether

we believe an error calculation or measure of variability must be computed with regard to the estimated value of the increase or decrease to inventory.

We believe that it is premature to respond to this question. The answer depends upon both further factual development and consultation with statistics experts to determine whether such an adjustment seems warranted in light of other adjustments which may be proposed. We will be happy to render further advice on this question should you deem it necessary.

IV. Change in Accounting Method

Treas. Reg. § 1.446-1(c)(2)(ii) provides that no method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting although the method is not specifically described in the regulations if income is clearly reflected by the use of such method. Also, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations if income is clearly reflected by the use of such method.

Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides that a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such plan. In most instances a method of accounting is not established for an item without consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change involving the method or basis used in the valuation of inventories. Section 1.446-1(e)(2)(ii)(c) states that a change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also, a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method accounting.

The regulations provide several examples of inventory changes in methods of accounting. Treas. Reg. § 1.446-1(e)(2)(iii), examples (6) and (7) are helpful for the instant issue. In example (6), taxpayer had been improperly computing cost because no overhead costs were included in valuing

the inventories at cost, and this was contrary to regulations. A change requiring allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory. In example (7) taxpayer had been valuing inventories by deducting 20 percent of the cost of inventory items in determining final inventory valuation, and this method was not a proper valuation method. Such method involves the treatment of a material item used in the overall practice of valuing inventory, and a change in such practice or procedure is a change in method of accounting for inventories.

In summary, where cost has been improperly computed or a change is made in the method of computing cost because it is not a proper valuation method, such change is a change in a material item used in the overall practice of identifying or valuing inventory, and is therefore, a change in method of accounting. See also LTR 85-41-004 (June 21, 1985) (if ending inventory changes due to a change in valuation method, cost of goods sold changes as does income; such change is a change in the method of accounting.)

In Korn Industries, Inc. v. United States, 532 F.2d 1352 (Ct. Cl.1976), taxpayer reincluded in its beginning inventories three cost elements that for a period of four years had inadvertently been excluded from inventories and expensed. The issue was whether this reinclusion amounted to a change in method of accounting. The court concluded that the taxpayer's inclusion of the previously excluded cost elements seemed more like a correction of a mathematical or posting error than a change in method of accounting.

In Rev. Rul. 77-124, 1977-1 C.B. 132, the Service stated that it would not follow Korn Industries. The ruling states that by including 11 items in its standard cost computation, taxpayer established a consistent pattern of treating those cost elements as well as the three excluded cost elements. Furthermore, the three excluded elements were material items because they involve the proper timing of items of income or expense. Since the taxpayer established a consistent pattern of treating material items, any change from that consistent pattern is a change of accounting method. In addition, the three omitted items are material items used in an overall plan for valuing inventory. Therefore, the change in their treatment is also a change in method of accounting under section 1.446-1(e)(2)(ii)(c).

If a change in method of accounting is involved, section 481 requires certain adjustments to income to prevent amounts from being duplicated or omitted from the computation of taxable income due to the change. The Commissioner may change a


taxpayer's method of accounting when it does not clearly reflect income. Electric & Neon, Inc. v. Commissioner, 56 T. C. 1324, 1333 (1971), aff'd, 496 F.2d 876 (5th Cir. 1974). However, when the Commissioner requires the change, he may not make adjustments relating to pre-1954 years. Section 481(a); Peoples Bank & Trust v. Commissioner, 50 T. C. 750, 754 (1968), aff'd, 415 F.2d 1341 (7th Cir. 1969). Section 481 applies not only to a change in taxpayer's overall method of accounting, but also to a change in the treatment of a material item. Treas. Reg. § 1.481-1(a)(1).

The purpose of section 481, of course, is to remove the distortion of income which results from accounting method changes, including inventory changes. The consistency requirement has been interpreted to mean that opening inventory for one taxable year must correspond to closing inventory for the preceding taxable year. Another aspect of the consistency requirement is that opening and closing inventory for the same taxable year must be computed on a consistent basis. When these two aspects of the consistency requirement are considered together, it is apparent that any significant change in a method of valuing inventories can result in a distortion of income, particularly if the statute of limitations has expired for prior years. This distortion is caused by the fact that when an accounting method is changed, resulting in an adjustment to the closing inventory, a comparable adjustment must be made to opening inventory, as well as to the closing and opening inventories for preceding years.

In summary, the disallowed adjustments to book inventory figures are changes in taxpayer's method of accounting and require a section 481 adjustment.

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